United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-7049

United States Court of Appeals

FOR THE SECOND CIRCUIT

ANITA B. BRODY,

Plaintiff-Appellant,

—against—

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK and THE FIDELITY BANK,

Defendants-Appellees,

—and—

PENNSYLVANIA COMPANY,

Defendant.

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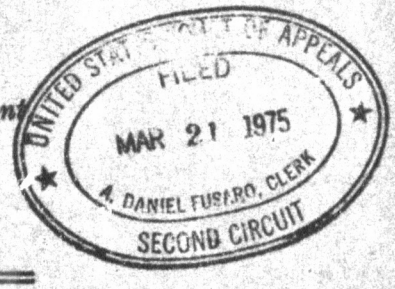

(ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK)

PLAINTIFF-APPELLANT'S BRIEF

WOLF POPPER ROSS WOLF & JONES
Attorneys for Plaintiff-Appellant
845 Third Avenue
New York, New York 10022
PL 9-4600

BENEDICT WOLF
LESTER L. LEVY
Of Counsel

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PRELIMINARY STATEMENT

This is an appeal from an order and a final judgment of the United States District Court for the Southern District

of New York (Gagliardi, J.), entered in this action on December 9, 1974 and February 10, 1975, respectively, dismissing the action with prejudice on the ground that plaintiff failed to satisfy the pleading requirements of Fed. R. Civ. P. 23.1.

ISSUES PRESENTED FOR REVIEW

1. Do the allegations of the second amended complaint, with respect to futility of making demand on Pennco's directors to commence suit, comply with the pleading requirements of Rule 23.1?

2. When a plaintiff has satisfied the pleading requirements of Rule 23.1 by either making demand or demonstrating the futility of making demand prior to the institution of suit, is she required either to again make demand or again to demonstrate the futility of making demand at the time of an amendment to her complaint after suit has been instituted?

3. Does an alleged wrongdoer have the right to assert the objection that no demand had been made on the directors of a derivative corporation prior to suit, when the purpose of the demand requirement is solely to protect the interests of the corporation and the corporation does not choose to assert the objection?

STATEMENT OF FACTS

This action by a holder of cumulative preferred stock of the nominal defendant, Pennsylvania Company ("Pennco"), is brought derivatively on behalf of Pennco. Plaintiff asserts that defendants Chemical Bank, Manufacturers Hanover Trust Company, Irving Trust Company, Chase Manhattan Bank, N.A., Bank of Montreal, Girard Trust Bank, and The Fidelity Bank (herein collectively, the "Defendant Banks" or "Defendants"), unwilling to lend monies to Penn Central Transportation Company ("Railroad") because of its weak financial condition, conspired with Railroad (which held all Pennco's outstanding common stock) (1) to cause Pennco to enter into a transaction with Defendant Banks pursuant to which Pennco borrowed $50,000,000 in exchange for Pennco's note; (2) to cause Pennco to turn these funds over to Railroad in return for notes of Railroad which were then, or would shortly become, almost worthless, as Defendant Banks knew; and (3) accordingly to use Pennco as a conduit by which to achieve Defendants' purpose of providing these funds to Railroad; all to the damage of Pennco and its preferred stockholders and to the benefit of Defendant Banks and Railroad.

Specifically, Railroad had a loss of more than $56,000,000 in 1969, and a loss of $62,700,000 in the first

quarter of 1970. On June 2[illegible].970, Railroad filed a petition under Section 77 of the Federal Bankruptcy Act (97a).

Sometime in or about early 1970, Railroad disclosed its dire financial situation to Defendant Banks, showing them confidential projections of its dismal financial future, and informing them of its critical need for funds. The information thus disclosed to Defendant Banks was not yet available to the public. Railroad requested a loan from said Banks, but they refused to lend funds directly to Railroad (98a).

Thereupon, Defendant Banks and Railroad conspired together to cause Pennco and did cause Pennco in or about May of 1970 to borrow $50,000,000 from Defendant Banks in exchange for Pennco's note and to transfer the proceeds of such borrowing to Railroad in exchange for worthless notes, either directly or through one of Railroad's subsidiaries. The aforesaid borrowing was not intended to serve and did not serve any proper business or corporate purpose of Pennco (98a). The terms of the loan were negotiated by representatives of Railroad with the Banks without any participation by any representative of Pennco.

The Defendant Banks knew, or had reason to know, that at the time of the loan transaction Railroad controlled

Pennco; Railroad's directors were also directors of Pennco; Railroad was compelling Pennco to borrow said $50,000,000; Railroad was the intended recipient of the loan; Railroad gave Pennco no fair or adequate consideration for the funds turned over by Pennco to Railroad; and Railroad was incapable of repaying said funds to Pennco (99a).

Plaintiff on behalf of Pennco asserts that the transfer of $50,000,000 by Defendant Banks to Railroad through Pennco violated §17(a) of the Securities Act of 1933 and constituted common law fraud, and seeks to rescind the improper loan in issue or to declare it void and to obtain on behalf of Pennco compensatory damages and recovery of the profits made by Defendant Banks and Railroad.

PRIOR PROCEEDINGS

Plaintiff did not make a demand on the Board of Directors of Pennco before commencing the action. Plaintiff instead pleaded in paragraph 26 of the amended complaint that she made no demand upon the directors of Pennco to take action with regard to the wrongs complained of because the directors are all designees of the controlling shareholder and wrongdoer, Railroad. Thus, to make a demand upon them would be to request them to sue the company that has chosen them and controls them.

Decision of District Court
July 26, 1972

On Defendant Banks' motion to dismiss the amended complaint for failure of plaintiff to make a demand upon the directors and common shareholder of Pennco to take action, or allege sufficient reasons for not making such demand, Judge Gagliardi stated that since the four Pennco directors in office at the time of suit were appointed to office subsequent to the time trustees had been appointed to manage the bankrupt Railroad, the allegations of the amended complaint that a demand would be futile were insufficient.

When plaintiff requested leave to replead in a second amended complaint additional facts showing the interrelationship between the Pennco Board in office at the time of suit and the pre-bankruptcy management of Railroad, that said directors were, for reasons of self-interest, not challenging the fraudulent loan in question, and that they had demonstrated their antagonism to plaintiff's efforts to attack the loan, Judge Gagliardi denied plaintiff leave to amend. He held that, assuming plaintiff could show that demand on the directors would have been futile, she could not excuse not making a demand on Railroad's trustees (Pennco's common stockholder). Judge Gagliardi granted Defendant Banks (the parties charged with helping to mulct Pennco of $50,000,000) judgment finally dismissing the action.

Decision of Court of Appeals
July 3, 1973

Plaintiff appealed the judgment to this Court. On July 3, 1973 the Court handed down its decision (482 F.2d 1111) in which it stated that the Court below had proceeded on an erroneous theory when it determined that stockholder demand was necessary. This Court also said that "In view of the gravity of the alleged wrongdoing" it could not agree with the final dismissal and was remanding the derivative action to the District Court.

In her briefs to this Court plaintiff had informed the Court that she wished to amend her complaint to allege additional facts showing the futility of making demand on the four Pennco directors in office at the time of suit, and she set forth the facts she would plead in a second amended complaint if she were given the opportunity. This Court gave plaintiff the choice of either repleading to comply with Rule 23.1,or making demand. Plaintiff chose to replead -- to amend her complaint to correct the insufficiency of her original paragraph 26.

The Second Amended Complaint

On January 9, 1975, plaintiff filed her second amended complaint. In paragraph 26 (100-104a) plaintiff spells

out in detail facts supporting her allegation that to make demand on the Pennco directors in office at the time of suit would have been futile.

In sum, plaintiff alleges that the Pennco directors, as of the time of the commencement of this action, were dominated by Railroad (100a); the directors had long and full knowledge of the wrongs alleged and had failed to seek redress (101a); the directors were attempting to secure a dismissal of an action by plaintiff in Philadelphia, which action, brought against the parent of Railroad and the former directors of Pennco, seeks to void the transaction complained of (101a); and the directors had a substantial personal interest in not antagonizing Defendant Banks or Railroad (102-103a).

More specifically, plaintiff alleges (101a) that on July 2, 1970 (at or about the same time that the trustees in Bankruptcy were appointed to manage Railroad's affairs and conserve its assets), plaintiff commenced an action in the Common Pleas Court of Philadelphia (the "Philadelphia Action"), the first cause of action of which was brought derivatively on behalf of Pennco against Penn Central Company, the parent of Railroad, and the then directors of Pennco, charging various wrongs committed against Pennco. One of the wrongs complained of was the fraudulent funnelling of $50,000,000 by various banks

through Pennco to Railroad, this being the same transaction which is the basis of the instant action. The complaint sets forth that the Board of Directors of Pennco, as of the date of the commencement of that action, instead of joining in the effort to set aside the loan transaction, or, at the very least, taking a neutral position, decided actively to oppose plaintiff's efforts to free Pennco from the $50,000,000 debt burden. In furtherance of this decision, the Board of Directors caused Pennco, in February, 1971, to file preliminary objections to the Philadelphia Action in an effort to have it dismissed. The directors of Pennco at the date this action was commenced (June 14, 1971) were still attempting to dismiss the Philadelphia Action and were taking no action to challenge the sham loan transaction, despite the fact that the Pennco Board knew of the transaction at least since the members of the Board started to serve (September-November, 1970)*.

It is not difficult to understand the opposition of the Pennco directors when, as plaintiff alleged (102a), the members of the Board knew, prior to the commencement of this action, of the likelihood that the retention of their positions and substantial fees would be controlled by a group of banks

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* In fact, Pennco stated in its answer that it was continuing to pay substantial monies in interest to Defendant Banks on the note in question.

(which included most of Defendant Banks) who had agreed to become the sole common stockholders of Pennco. Each of the four directors of Pennco at the time of the commencement of the action had a large financial stake in not antagonizing those banks. Directors McArthur and Whitney were receiving salaries in excess of $25,000 a year just for serving as directors (102a). Director Martinelli, who until his designation as director, had been an employee of Railroad, was receiving a salary substantially in excess of $25,000 as an officer and director of Pennco (102a). Director Palmieri, who was also President of Pennco, was a principal owner of a real estate investment and urban system counseling firm. His employment by Pennco was under a contract pursuant to which his firm received $300,000 a year, two-thirds paid by Pennco and one-third by its subsidiary, Great Southwest Corporation (102a).

At the date of the commencement of this action these directors knew that negotiations were in progress between Railroad and a group of financial institutions, including most of Defendant Banks (negotiations in which Pennco director Palmieri actively participated) whereby Railroad would turn over to the financial institutions all of its Pennco common stock in exchange for the cancellation of a $300,000,000 loan and certain other benefits. The completion of this transaction

would have resulted in the Defendant Banks becoming substantial stockholders of Pennco, and thus in a position to exercise a decisive voice in determining the retention of the Pennco directors in their positions and their continued receipt of their substantial financial benefits from Pennco (102-103a).

Decision of the District Court
December 9, 1974

On February 8, 1974, Defendant Banks moved to dismiss the second amended complaint pursuant to Fed. R. Civ. P. 12(b)(6). Said defendants argued that the facts pleaded by plaintiff do not show the futility of demand on the Pennco board in office at the time of suit. This issue was extensively briefed by both sides, with plaintiff pointing out that the Court of Appeals, before it set aside the District Court's final dismissal of the derivative counts, had been informed by plaintiff, in detail, of the allegations concerning futility of demand which her second amended complaint would contain and Defendant Banks had argued vigorously to the Court of Appeals their position that the allegations that plaintiff sought to include in her second amended complaint would not show futility of demand at the time of suit and that, accordingly, the Court of Appeals should affirm the final dismissal of the derivative counts.

The Court of Appeals impliedly rejected these arguments when it set aside the final dismissal and remanded

the derivative action. Plaintiff pointed out that it is reasonable to assume that the Court of Appeals would not have reversed the final dismissal of the derivative action and would not have made the useless gesture of remanding the case to the District Court if the allegations plaintiff sought to insert in her repleaded complaint would not withstand a motion to dismiss. Plaintiff also emphasized that Pennco had not raised any objection to plaintiff's not having made a demand on the Pennco directors to bring this action. Rather, it is Defendant Banks, charged with perpetrating a fraud on Pennco, who seek to assume the role of protector of Pennco's rights.

On December 9, 1974, Judge Gagliardi dismissed the second amended complaint (109-113a). He based his decision on an argument not raised by any party -- that plaintiff should have made demand, not on the Board in office at the time of commencement of the action, but on the Board in office at the time she filed her second amended complaint, two and a half years after suit was commenced.* On the basis of this theory, for which Judge Gagliardi cited no authority, he found the second amended complaint defective for plaintiff's failure to allege futility of demand on the new Board.

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* By that time four new members had been added to the Board of Directors.

It is submitted that the result reached by the Court below is contrary to Rule 23.1 and Rule 15 of the Fed. R. Civ. P. Since the present allegations of the second amended complaint satisfy the pleading requirements of Rule 23.1 this Court should set aside the judgment, deny Defendants Banks' motion to dismiss and allow this case to proceed to a determination on its merits.

ARGUMENT

POINT I

THE ALLEGATIONS OF THE SECOND AMENDED COMPLAINT SATISFY THE PLEADING REQUIREMENTS OF RULE 23.1.

Rule 23.1 provides in pertinent part that the complaint allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors, and the reasons for his failure to obtain the action or for not making the efforts.

It is well-settled that on a motion to dismiss a complaint for failure to state a claim upon which relief can be granted, the allegations of the complaint must be accepted as true. Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); 2A Moore's Federal Practice §12.15 (2d Ed. 1971).

Specifically, with respect to a motion alleging a failure to satisfy Rule 23.1, the allegations of futility of demand must be accepted as true for the purposes of the motion. Papilsky v. Berndt, 17 F.R. Serv. 2d 214 (S.D.N.Y. 1973); Dopp v. American Electronic Laboratories, Inc., 55 F.R.D. 151 (S.D.N.Y. 1972).

Judge Weinfeld, in denying defendants' motion to dismiss in Popp v. American Electronic Laboratories, Inc., supra, said:

> "These allegations, the verity of which must be accepted on this motion, support plaintiff's claims that any further demand upon Butler would be futile and are sufficient to comply with the pleading requirements of Rule 23.1." 55 F.R.D. at 153-154 (Emphasis added)

Of course, it is also well-settled that the complaint should be liberally construed and considered in the light most favorable to the plaintiff. Conley v. Gibson, 355 U.S. 41 (1957); Anderson v. Pennsylvania R.R., 143 F. Supp. 411 (S.D.N.Y. 1956) Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962). In considering this motion addressed to the complaint, the Court should be guided by the principals enunicated by the Supreme Court in Conley v. Gibson, supra, where Mr. Justice Black stated:

> "In appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." 355 U.S. at 45-46.

It is undisputed that pursuant to Rule 23.1 demand for action on directors is dispensed with where such demand would be futile, useless or unavailing. Where the directors are antagonistic, adversely interested or involved in the transaction attacked, a demand on them is presumptively futile and need not be made. Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85 (2d Cir. 1955); Kaminsky v. Abrams, 281 F. Supp. 501 (S.D.N.Y. 1968); Papilsky v. Berndt, supra.

In Del. & H. Co. v Albany & S.R. Co., 213 U.S. 435 (1909), the Supreme Court held that, in excusing demand, the good faith of the directors need not be questioned,their attitude may not be sinister and, in fact, they may be sincere. Demand will be excused when the directors occupy antagonistic grounds to plaintiff in respect to her claims.

Plaintiff, in paragraph 26 (100a-104a) of her second amended complaint, sets forth with particularity facts amply supporting her allegation that Pennco's directors at the time this action was commenced were clearly antagonistic to her claims and demand on them for action would have been futile, useless and unavailing.

The facts supporting the allegation of futility are those relating to the Board's action in the Philadelphia

case (supra, pp. 8-9), their failure to challenge the sham loan transaction despite their long-time knowledge of it (supra. p. 9 and their interest in preserving their financial stake in the rentention of their positions and therefore the goodwill of the Defendant Banks (supra. pp.9-10), as well as the other facts alleged in paragraph 26 of the second amended complaint (100a-104a). These more than adequately meet the pleading requirements of Rule 23.1.

It has also been held that in deciding whether demand need be made on a derivative corporation prior to the initiation of an action on its behalf by a shareholder, the Court should consider the whole complaint and not merely the paragraph in which plaintiff summarized her reasons for not demanding action by the corporation, to see if equity compels that demand be excused. Cohen v. Industrial Finance Corp., 44 F. Supp. 491 (S.D.N.Y. 1942); In re Kauffman Mutual Fund, 479 F.2d 257 (1st Cir. 1973); 7A Wright & Miller, Federal Practice and Procedure: Civil §1832, at 392 (1972).

The nature of the transaction at issue must also be taken into account. In re Kauffman Mutual Fund, supra. The wrongful acts which are the subject of the instant action concern an arrangement entered into between Defendant Banks and Railroad (which held all of Pennco's outstanding common stock) to cause

a solvent Pennco to borrow fifty million dollars from the banks for Pennco's note and then immediately turn the funds over to Railroad for a worthless note. This loan transaction left Pennco with a fifty million dollar debt on its books. The transaction served no corporate purpose of Pennco and was negotiated by Railroad and the banks without any participation by Pennco.

The Court in Kauffman, supra, said (in regard to the nature of the alleged misconduct) that logic suggests a sharp distinction between a transaction completely undirected to a corporate purpose and one which while perhaps vulnerable to criticism, is of a character that could be thought to serve the interest of the company.* If a director does not challenge an act on its face harmful to the corporation and advantageous only to some other person it may be assumed that demand on him is presumptively futile. His attitude is "prima facie inexplicable." 479 F. 2d at 265.

The conduct alleged in the present case is undirected to any legitimate corporate purpose of Pennco. On its face this transaction, which left Pennco with a fifty million dollar debt and only benefited Railroad and the banks, is improper.

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* The transaction in Kauffman involved the latter; while the "sham loan" in question, benefited only Railroad and the Banks, and is a perfect illustration of the former.

In light of the nature of the transaction challenged, the history of the Pennco directors' antagonism to plaintiff's challenge to this transaction, the self-interest of the directors -- and all the other allegations in paragraph 26 of the second amended complaint, we respectfully submit that plaintiff has satisfied the requirements of Rule 23.1 and should be allowed to prosecute this action.

POINT II

UNDER RULE 23.1 DEMAND ON A BOARD OF DIRECTORS MUST BE MADE PRIOR TO COMMENCEMENT OF SUIT, OR IN THE ALTERNATIVE, DEMAND PRIOR TO COMMENCEMENT OF SUIT MUST BE FUTILE. AMENDMENT OF A COMPLAINT DOES NOT CHANGE THIS TIME REQUIREMENT.

Plaintiff has complied with the requirements of Rule 23.1 since she has demonstrated the futility of making a demand on the Board of Directors of Pennco to bring the instant litigation prior to the institution of suit. There is nothing in the Rule which requires her either again to make a demand or again to demonstrate the futility of making such a demand after suit has been instituted. Nelson v. Pacific Southwest Airlines, CCH Trade Reg. Rep. [¶60,124; 1975 Trade Cases (S.D. Calif. Jan. 16, 1975)]; Cf, In Re Kauffman Mutual Fund Actions, supra, where the court held that plaintiff has to show that demand was futile "at the time of suit." (479 F.2d at 264)

It has been recognized that any other interpretation of Rule 23.1 would be overly burdensome to plaintiffs in derivative suits. Election of directors usually occurs annually, and more frequent changes may result from death, resignation or removal. If a plaintiff were required to make a demand and file an amended complaint every time that a change in the

composition of the Board of Directors occurred, the result would be to further delay already protracted litigation. Nelson v. Pacific Southwest Airlines, supra.

The requirement which has been established by the court below, demand at the time of the amendment of the complaint, is so impractical that it must be rejected. The first problem which arises is whether demand is to be made on the Board in office when the case was started or on the Board in office when the complaint was amended. The next problem is to determine what plaintiff should ask the Board to do, start a new action on the basis of the facts alleged in the instant case or take over the case. To ask that the Board start an action might have been a feasible demand before the present action was instituted, but it obviously makes no sense now, several years later. As for a demand on the Board of Pennco to take over the present action, it must be borne in mind that the Board could have done so at any time since the action was started by simply making a motion to align itself as a party plaintiff, assuming it was prepared to convince the court that it would prosecute the action in good faith.

The requirement that a demand be made on the Board of Directors in existence at the time of amendment of the complaint is not only so impractical as to be meaningless, but

it is also in direct contravention of the express language of Rule 15(c), as is a direction that the allegations of futility of demand must relate to the time of the filing of the second amended complaint rather than to the time of the commencement of the action. Rule 15(c) expressly provides: "Whenever the claim . . . asserted in the amended pleading arose out of the conduct, transaction or occurrence set forth or attempted to be set forth in the original pleading, the amendment relates back to the date of the original pleading."

It is axiomatic that an amendment which corrects deficiences or expands or modifies the facts alleged in a complaint relates back to the date of the filing of the original complaint. Tiller v. Atlantic Coast Line R. Co., 323 U.S. 574 (1945); United States v. Somers Construction Co., 184 F. Supp. 563 (D. Del. 1960); Court Degraw Theatre v. Loew's Inc., 22 F.R.D. 264 (E.D.N.Y. 1958); 6 Wright & Miller, Federal Practice and Procedure: Civil §1497 at 490,495.

The amendment of the complaint made by the plaintiff in January, 1974, pursuant to permission granted by this Court to replead in conformity with Rule 23.1 clearly comes within the ambit of the foregoing decisions.

Thus, Judge Gagliardi's dismissal of the action on the novel ground that the allegations of futility of demand must

relate to the time the complaint is amended, rather than to the time suit was brought, is contrary to Rule 23.1, would, if adopted, serve to prolong litigation, serves no practical purpose, and is contrary to Rule 15.

POINT III

THE RIGHT TO OBJECT TO A FAILURE TO MAKE DEMAND BELONGS EXCLUSIVELY TO THE CORPORATION ON WHOSE BEHALF THE ACTION IS BROUGHT.

It is important to note that Pennco has not raised any objection to plaintiff's not having made a demand on its directors. However, Defendant Banks, charged with defrauding the corporation, seek to secure the dismissal of the action against them because plaintiff did not make demand on the Pennco Board to bring the action.

We are aware that in numerous instances in the past, alleged wrongdoers have been permitted to raise a plaintiff's failure to comply with the demand requirements of Rule 23.1 as the basis for a motion to dismiss stockholders derivative action. But in not one of these cases did the plaintiff challenge the right of any defendant other than the corporation to use this defense or assert that the right to insist on prior demand belongs only to the corporation on whose behalf the action was brought. In the few instances where the Courts have considered the propriety of allowing the wrongdoers to assert the failure to make demand as a defense they have indicated that this defense belongs exclusively to the corporation.

In Koral v. Savory, Inc., 276 N.Y. 215, 221 (1937), the issue boiled down to whether the action should be brought in the name of the corporation receiver or by the stockholders derivatively. The Court sustained suit by the latter over the protest of the wrongdoer defendants, stating that:

> "The alleged wrongdoers may not dictate how the choice should be exercised."

In Ripley v. International Railways of Cent. America, 8 App. Div. 2d 310, 188 N.Y.S. 2d 62 (1st Dept. 1959), aff'd. 8 N.Y. 2d 430 (1960), International Railways of Central America ("IRCA") commenced a derivative action against defendant United Fruit Company ("UFCo") for damages resulting from various wrongs alleged to have been committed by UFCo against IRCA. In the action UFCo claimed, inter alia, that plaintiffs failed to prove a demand on IRCA and refusal to sue. The Court responded by stating:

> "It is questionable whether UFCo may raise this defense since IRCA does not press it. Such a defense appertains to IRCA: it cannot have any bearing on the cause of action asserted on behalf of IRCA against UFCo. Certainly, the alleged wrongdoer ought not to be able to dictate whether the injured corporation or minority stockholders in a derivative capacity should bring this suit. Koral v. Savory, Inc., 276 N.Y. 215, 11 N.E. 2d 833." (188 N.Y.S. 2d at page 72).

Policy, as well as sound theory, stands in the way of letting the wrongdoers urge Pennco's objection which the latter does not wish to assert. The objection is available to the represented corporation, not for the purpose of shielding a wrongdoer, but for the purpose of permitting a corporation, where that is practicable, to protect its own interest.

The purpose of the demand requirement is set forth in Delaware & H. Co. v. Albany & S.R. Co., supra, where the Court stated that the demand requirement ...."recognizes the right of the corporate directory to corporate control; in other words, to make the corporation paramount, even when its rights are to be protected or sought through litigation". 29 S. Ct. at 543.

The demand requirement should be interpreted to achieve the corporation's objectives and not to result in an unintended and inimical purpose (i.e. to protect those charged with defrauding the corporation). Delaware & H. Co. v. Albany & S.R. Co., supra; Cohen v. Industrial Finance Corp., supra.

Rule 23.1, based as it is in Equity Rule 27, should be applied in a way to secure an equitable result, to achieve the purpose for which it was adopted. The fact that the issue has not been squarely raised in the past is not a sound reason to refuse to consider it when it is properly raised now.

To continue the practice of permitting any defendant other than the corporation to use failure to make demand as a defense defeats the purpose of the demand requirement, the right of the corporation to decide whether it wishes to exercise its privilege of starting an action. The corporation may wish to waive that privilege and permit a stockholder to act on its behalf, albeit without its cooperation or blessing. If the wrongdoing defendants can use the defense of failure to make demand, they are depriving the corporation of this right of waiver.

There may be situations where a corporation may conclude that it will be impolitic for it to commence a lawsuit, but where it is more than willing to accept the fruits of a derivative suit brought on its behalf. In the instant action, Pennco, because of its need for large scale financing, which must be supplied by the financial community of which the Defendant Banks are an important part, may have to conclude, however reluctantly, that it cannot sue to set aside the $50,000,000 loan. Yet it may welcome a suit for its benefit by a stockholder.

We note that in its answer, Pennco has not foreclosed the possibility of benefiting through this action, since

it requests such relief as it may be entitled to "on the basis of the facts as they ultimately appear herein and submits its rights to the decision and judgment of the Court."

We respectfully submit that the question we have raised, the right of any defendant other than the concerned corporation to raise the defense of failure to make demand, is of sufficient importance to require determination, and urge that to achieve the purpose for which Rule 23.1 was adopted, the preservation of the right of a corporation to control its own affairs, the use of this defense should be limited to the concerned corporation.

CONCLUSION

For the reasons stated herein this Court should vacate the judgment of the District Court, deny Defendant Banks' motion to dismiss and allow this case to proceed to a determination on its merits.

Respectfully submitted,

WOLF POPPER ROSS WOLF & JONES
Attorneys for Plaintiff-Appellant
845 Third Avenue
New York, New York 10022

BENEDICT WOLF
LESTER L. LEVY

OF COUNSEL

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Attorneys for Defendant-Respondent Bank of Montreal

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Attorneys for Defendant-Respondent Pennsylvania Co.

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